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Does the EU have leverage on sustainable bond markets?

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Key Points

- By funding a large share of Next Generation EU and SURE facilities through the issuance of green and social bonds, the European Commission has temporarily established itself as a major player in these market segments.
- These measures align with the Commission's wider agenda of using green bonds to strengthen European capital markets and the international role of the euro.
- But ensuring that these bonds comply with their label poses governance challenges.
- As the Commission has failed to align its large-scale bond issuance with the new EU Green Bond Standard that it developed, it remains questionable whether this strategy will have a lasting impact.

Introduction

In 2021, the European Commission issued both the largest ever single green bond and the largest social bond in the world and established itself as a leading player on sustainable bond markets (Environmental Finance, 2021). Given that, prior to 2020, the Commission had only tapped capital markets sporadically, these are significant developments.

As this brief details, the Commission's decision to fund large portions of the Next Generation EU and SURE facilities through so-called sustainable bonds have nevertheless delivered only mixed results. Although the Commission's sustainable bond auctions have been highly successful at attracting investors, its efforts contribute little to the EU's wider objective of setting international standards for sustainable bonds. In fact, the programmes will be terminated before the EU's new rules for green bonds enter into force. Moreover, the sustainable bonds that the Commission has issued under NGEU and SURE face regulatory problems that leave the EU vulnerable to accusations of greenwashing.

The EU's role in sustainable bond markets

The Commission's forays into sustainable bond markets were a bold decision. In 2020, President von der Leyen declared that 30% of the Next Generation EU facility of €750 billion would be funded through green bonds (European Commission, 2020b); and the entire €100 billion of the SURE facility would be raised through social bonds.

Such volumes would inevitably impact these markets. Green and social bonds are, after all, relatively new financial products. Although their markets have grown sharply they are still fairly small, with market volumes of about $500 billion of social bonds and close to $1.9 trillion of green bonds outstanding in 2022.[1]

European capital markets have been central to promoting sustainable bonds. Indeed, the first green bond in history was issued by the European Investment Bank, another EU body, on the Luxembourg Stock Exchange in 2007. In 2021, almost half of all outstanding sustainable bonds were denominated in euros, twice the common currency's share across all international securities (Environmental Finance, 2021; European Central Bank, 2022).

The Commission has aimed to strengthen the position of the EU in green finance. In October 2021 it issued the largest single green bond ever, at a coupon of €12 billion – and there was so much demand that the EU could have raised ten times more (Christie, Claeys, & Weil, 2021). Its position on social bond markets is even more impressive since its SURE Social Bonds accounted for 38% of total issuance in 2021.[2] In short, the Commission has rapidly become a dominant player on sustainable bond markets.

Regulatory ambitions

The Commission did not just aim to deepen sustainable bond markets by issuing large volumes, but also to set global regulatory standards. Already in 2018 it had declared its goals of developing an EU taxonomy of sustainable activities and of establishing a European 'gold standard' for green bonds (European Commission 2021a). However, in this respect the Commission's approach is less impressive than its market position.

To begin with, the Commission missed the chance to align its own sustainable bonds with the standards that it was developing. Instead of the new criteria developed on the EU level, the NGEU Green Bond and the SURE Social Bond are based on the voluntary 'Green and Social Bond Principles' of the International Capital Market Association (ICMA), a private regulator.

In part, this was due to bad timing. The EU's Green Bond Standard is still under negotiation as of early 2023 and will likely not enter into force before the NGEU facility is completely funded. Furthermore, the Commission had scrutinized and approved most National Recovery Plans prior to the agreement on the taxonomy, the criteria of which were thus not applied to assess the plans.

However, there are several drawbacks of only applying the ICMA Principles as the German Federal Audit Court reports. These Principles only outline reporting procedures for green bonds; they fail to set the standards for evaluating the climate impact of projects (which the taxonomy provides). The European Commission is therefore not able to draw on the taxonomy to determine which of the projects that it is funding can be deemed climate-friendly. This means that the Commission's green bonds are subject to less stringent standards than those of private issuers who have had to comply with the taxonomy since 2022 (Bundesrechnungshof, 2022, p. 12).

By not bringing its green and social bonds in line with the new EU guidelines, the Commission has thus weakened its ability to establish NGEU and SURE bonds as a global benchmark.

Questionable safeguards

Ensuring that the NGEU Green Bonds actually fund green projects is also a challenge for governance. This owes to the multi-level character of the Recovery and Resilience Facility, where the European Commission issues the green bonds, but the Member States are responsible for implementing the projects. To obtain the 'green bond' label, the

[1] Source: Climate Bonds Initiative

[2] Source: Climate Bonds Initiative.

Commission and the recipient Member States are subject to detailed allocation and impact reporting requirements (European Comission, 2021b). Notably, however, only the reporting structure has been approved by a third-party evaluator under the ICMA Principles. By contrast, project assessments take place according to the Commission's criteria.

The Commission has given itself a margin to ensure that green bonds will only fund green projects. While NGEU Green Bonds fund 33% of the NGEU facility, at least 37% of each National Recovery Plan has to support the green transition and most member states are far above this value.[3]

Still in some cases it is possible that the European Commission may be accused of greenwashing. The Bundesrechnungshof (2022, pp. 21-23) details how, by not applying taxonomy criteria, the Commission might overestimate the climate impact of National Recovery Plans. Ultimately, this could result in more money being raised through green bonds than is warranted by the climate impact of the projects. Such doubts could damage the Commission's reputation as a credible issuer.

Although the governance and reporting of SURE Social Bonds is analogous, the risk of misallocated funds appears more limited in that case. Member states were only able to use their proceeds for a limited range of short-term work support schemes (European Commission, 2020a). Nevertheless, it bears mentioning that the social character of these projects is justified based on the ICMA principles which cover programmes 'designed to prevent and/or alleviate unemployment stemming from socioeconomic crises', rather than a European framework for assessment (European Commission, 2020a, p. 6).

The way forward

The Commission's efforts to use its SURE and Next Generation EU borrowing to establish itself as a player on sustainable bond markets warrant a mixed assessment. Without doubt, the Commission's bond issues have attracted wide investor interest. Between 2020 and 2023, the Commission will be one of the world's leading issuers in these market segments.

However, there are reasons to doubt that the two programmes will have a lasting impact beyond that period. The Commission has failed to align its green and social bond issues with the taxonomy and Green Bond Standards that the EU is developing, which has notably left the NGEU Green Bonds in a regulatory grey zone. Thus, the Commission's green bonds are unlikely to function as a benchmark – in fact, they might even lead to accusations of greenwashing.

Now that the NGEU and SURE facilities are almost fully funded and future large-scale EU borrowing appears a remote prospect, it is unlikely that the Commission will establish itself as a player that can successfully promote the EU's sustainable bond standards. More plausibly, other EU actors may be able to continue this market activism: the European Investment Bank (2021, p. 26) is rapidly shifting its funding towards green bonds and even the European Stability Mechanism (2020) has developed a framework for issuing social bonds.

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[3] Source: https://www.ngeutracker.org/about: NGEU - Recovery and Resilience plans, Luxembourg's Recovery Plan scores highest, with 60% funding the green transition.

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Further Information

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